Supreme Court, U. S.
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In The

Supreme Court of the United States

79-66

October Term, 1979

No. A-1068

PETER E. AARON,

Petitioner,

vs.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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In The

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October Term, 1979

No. A-1068

PETER E. AARON,

Petitioner,

vs.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The petitioner Peter E. Aaron respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Second Circuit entered in this proceeding on March 12, 1979.

OPINION BELOW

The opinion of the Court of Appeals, not yet reported, appears in the Appendix hereto. The opinion of the District Court for the Southern District of New York (1977-1978 Transfer Binder) Fed. Sec. L. Rep. (CCH) 96,043 (S.D.N.Y. May 5, 1977), appears in the Appendix hereto.

JURISDICTION

The judgment of the Court of Appeals for the Second Circuit was entered on March 12, 1979. An order extending the time to file this petition for a writ of certiorari was granted on June 11, 1979 to and including July 10, 1979. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

QUESTIONS PRESENTED

1. Whether the Securities and Exchange Commission is required to establish scienter as an element of a government enforcement action to enjoin violations of §10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), and Securities and Exchange Commission Rule 10b-5, 17 CFR §240-10b-5 (1975), or of Section 17a of the Securities Act of 1933, 15 U.S.C. §77q(a).

STATUTORY PROVISIONS INVOLVED

Securities Act of 1933:

> "§17a. Fraudulent Interstate Transactions
>
> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly —
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

Securities Exchange Act of 1934, §10(b) Manipulative and Deceptive Devices:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —
>
> (b) To use or employ, in connection with the purchase of sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Securities and Exchange Commission Rules:

> "Rule 10b-5 Employment of Manipulative and Deceptive Devices
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange.

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

STATEMENT OF THE CASE[1]

A. Peter Aaron's Responsibilities With E.L. Aaron & Co.

During the period in question, appellant Peter E. Aaron ("Aaron") was employed by E.L. Aaron & Co. ("Aaron & Co." or "the firm"). Aaron & Co. was a broker-dealer registered with the Securities and Exchange Commission ("SEC"). The firm's principal office was in New York City. Aaron's father, Edward L. Aaron, was president and sole shareholder of Aaron & Co.

Aaron had been employed by the firm for 15 years. He served as his father's assistant. He was the firm's trouble shooter and the liaison between the firm's various departments, including operations, sales and the trading room.

Aaron maintained the so-called due diligence files for securities in which the firm made markets. In connection with his supervision of the firm's sales force, Aaron conducted sales

1. The statement of the case is recited *verbatim* from the Second Circuit's opinion.

meetings with registered representatives. At these meetings sales techniques were discussed. He also monitored the registered representatives' trading — by advising them of their monthly production figures, by informing them when any of their clients were late in payment, and by discouraging the representatives from exceeding their individual selling capacities.

As compensation for his services, Aaron received salary, bonuses and expenses at a level comparable to that of his father, the firm's president. Aaron, however, was not registered with the National Association of Securities Dealers ("NASD") as a principal of Aaron & Co. He held no corporate office in the firm.

B. Offer and Sale of Lawn-A-Mat Stock

In November 1974, Aaron & Co. opened a branch in Roslyn Heights, New York. Norman Schreiber, a registered representative of Aaron & Co., was appointed branch manager of the new office. Donald Jacobson, also an Aaron & Co. registered representative, was assigned to assist Schreiber. The Roslyn Heights office was essentially a two-man operation.

From November 1974 through September 1975, Aaron & Co. made a market in the common stock of Lawn-A-Mat Chemical & Equipment Corp. ("LAM"). In doing so, Schreiber and Jacobson contacted stockholders of LAM and its franchise-dealers by phone and by mail to solicit orders for LAM stock. In the course of this promotion, Schreiber and Jacobson made false and misleading statements to prospective purchasers of LAM. Among the statements made were some to the effect that LAM was planning or in the process of manufacturing a new type of small car and a tractor. In fact LAM had no plans to manufacture a car or tractor. Schreiber and Jacobson also made projections of substantial increases in the price of LAM stock and misleading statements about LAM's financial condition.

There was no basis in fact for these projections and statements, since LAM had experienced significant losses during the period involved.

Some of the persons contacted complained to LAM officers about these statements. The LAM officers informed both Schreiber and Jacobson that their statements were false.

When the false and misleading statements continued despite these warnings, LAM's attorney contacted Aaron. He did so twice by telephone during the period involved, informing Aaron of the continuing false and misleading statements by his sales representatives.

Since Aaron was in charge of LAM's due diligence files, he had ample independent reason to know that the information about LAM being disseminated by Schreiber and Jacobson was untrue. Although Aaron notified Jacobson of the LAM attorney's complaint, he did nothing whatsoever to stop the false and misleading statements being made by Schreiber and Jacobson.

C. The Aaron & Co./J. W. Weller & Co./Dorfman Transactions

In November 1974, a representative of Aaron & Co. telephoned Daniel Dorfman, who was then the president, principal stockholder and a director of LAM, to solicit the sale by Dorfman of 1,000 shares of LAM common stock. Since Dorfman was a controlling person of LAM, his shares could not be sold unless registered under §5 of the 1933 Act or unless the sale of the unregistered stock qualified for an exemption from registration pursuant to Rule 144 under the 1933 Act. In view of the fact that Aaron & Co. precipitated the entire transaction by arranging for the sale of shares from Dorfman to Weller and by soliciting customers' buy orders in anticipation of the transfer of

the shares from Weller to Aaron & Co., the sale of the shares to the public obviously did not qualify for a Rule 144 exemption, as we hold below.

In an attempt to enable Aaron & Co. to sell Dorfman's unregistered stock without qualifying for a Rule 144 exemption, the firm arranged the following transaction. Aaron contacted J.W. Weller & Co., Inc. ("Weller"), another broker-dealer, and suggested that Weller act as an intermediary for sales from Dorfman to Aaron & Co. The proposal was that Dorfman would sell his shares to Weller which, as "agent" of the selling shareholder, would sell the shares to Aaron & Co., which in turn would solicit buyers for the shares. Weller agreed. The transaction was consummated. Daniel Dorfman sold 1,000 shares.

Similarly, in February 1975, a representative of Aaron & Co. persuaded Fred Dorfman, who was then vice-president and a director of LAM, to sell 20,000 shares of LAM common stock in the same manner. As with Daniel Dorfman, Fred Dorfman was a controlling person. He was directed to transfer his shares to Weller, which in turn delivered them to Aaron & Co. for public sale.

The SEC commenced the instant enforcement action in the District Court on February 26, 1976. It sought preliminary and final injunctive relief pursuant to §20(b) of the 1933 Act, 15 U.S.C. §77t(b)(1976), and §21(d) of the 1934 Act, 15 U.S.C. §78u(d) (1976). The complaint charged Aaron and three other defendants with violating and aiding and abetting violations of, the registration provisions of §§5(a) and 5(c) of the 1933 Act, 15 U.S.C. §§77e(a) and 77e(c) (1976). The complaint also charged Aaron and seven other defendants with violating, and aiding and abetting violations of, the antifraud provisions of §17(a) of the 1933 Act, 15 U.S.C. §77q(a) (1976), §10(b) of the 1934 Act, 15 U.S.C. §78(b) (1976), and Rule 10b-5 promulgated under the

1934 Act, 17 C.F.R. §240.10b-5 (1978). The seven defendants other than Aaron consented to the entry of permanent injunctions against them.

After a three day evidentiary hearing, the District Court held that Aaron had violated the registration and anti-fraud provisions as charged in the complaint; and that the SEC was entitled to a permanent injunction enjoining Aaron from further such violations.

The judgment rendered by the District Court was affirmed by the Court of Appeals. The Court of Appeals held, in short, that in the context of an enforcement action brought by the SEC to enjoin violations of §10(b), proof of scienter on the part of the defendant is not required. In addition, the Court of Appeals also held "that the SEC was (not) required to prove scienter with respect to that part of this injunction action brought pursuant to §17(a)."

REASONS FOR GRANTING THE WRIT

I.

The decision below conflicts with the decisions of other courts of appeals as to whether scienter is an essential element of a SEC injunction action under Section 10(b) of the Securities Exchange Act of 1934 or of Section 17(a) of the Securities Act of 1933.

In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), this Court held that proof of scienter is a necessary element in a private damage action under §10(b). This Court also stated:

> "Since this case concerns an action for damages, we also need not consider the questions whether scienter is a necessary element in an action for injunctive relief under §10(b) and Rule 10b-5.

> Cf. *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 11 L at 2d 237, 84 S Ct. 275 (1963)."
> 425 U.S. at 194 n. 12.

In reliance upon its "carefully reasoned pre-*Hochfelder* decisions", the language and history of Section 10b, and the compelling distinction between private damage actions and government injunction actions, the Second Circuit has here held that "the scienter requirement enunciated in *Hochfelder* is not applicable to government enforcement actions brought under 10(b) of the 1934 Act and §17(a) of the 1933 Act.

In so holding, the Second Circuit conceded that its interpretation of §10(b) conflicts with that adopted by the Fifth Circuit in *SEC v. Blatt*, 583 F. 2d 1325, 1333 (5th Cir. 1978). Moreover, the Second Circuit conceded that its interpretation of §17(a) conflicts with that adopted by the Seventh Circuit in *Sanders v. John Nuveen & Co.*, 554 F. 2d 790, 795-796 (7th Cir. 1977).

The Second Circuit here found "the language of Section 10(b) alone is not determinative of the issue and that resort to legislative history and purpose is proper."[2] *See* page 15a of the Appendix, *infra*. In discussing the legislative history, the Second Circuit examined §21(d) of the 1934 Act, the explicit statutory provision which authorizes the SEC to bring an injunctive action. The Second Circuit found that Congress expressly indicated at the time of the enactment of §21(d) that SEC injunction actions are exempt from the scienter requirement applicable to private action (17a).

---

2. In *Hochfelder*, at 214, n. 33, this Court stated, "As we find the language and history of §10(b) dispositive of the appropriate standard of liability, there is no occasion to examine the additional considerations of 'policy', set forth by the parties, that may have influenced the lawmakers in their formulation of the statute."

In addition, the Second Circuit held that policy considerations underlying the Securities Acts clearly reflect that a negligence standard should be applied in a government enforcement action (14a). These holdings completely conflict with *Blatt, supra.* There, the Fifth Circuit held that the language and history of §10(b) as analyzed and discussed in *Hochfelder,* conclusively demonstrates that scienter is a necessary element in a government enforcement action. 583 F. 2d 1332. The Fifth Circuit further stated that the language of §10(b) is sufficently clear in its context, and thus controlling, notwithstanding considerations of public policy. 583 F. 2d 1332. Thus, the conflict between the decision below and *Blatt* is complete.[3]

Moreover, the Second Circuit, relying on its discussion of §10(b) and its previous analysis in *SEC v. Coven,* 581 F. 2d 1020, 1026-1028 (2d Cir. 1978), held that scienter is not required in an SEC injunction action under §17(a) (18a-19a). This holding also completely conflicts with the Seventh Circuit's determination in *Sanders v. John Nuveen & Co., Inc., et al.,* 554 F. 2d 790 (7th Cir. 1977). In *John Nuveen & Co., Inc.,* the Seventh Circuit held that for the reasons expressed in *Hochfelder,* scienter is a necessary element under §17(a). 554 F.

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3. The Tenth Circuit has apparently followed the Fifth Circuit in finding that scienter is a necessary element of a government enforcement action. *Edward J. Mawod & Co. v. SEC,* 591 F. 2d 588, 595 (10th Cir. 1979). *See also, SEC v. Willis,*____ F. Supp. ____ (D.D.C. 12/14/78). [Scienter is an essential element of a SEC injunction action under Section 10(b).] *SEC v. Cenco, Inc.,* 436 F. Supp. 193, 200 (N.D. Ill. 1977); *SEC v. Bausch & Lomb, Inc.,* 420 F. Supp. 1226, 1241 (S.D.N.Y.), *aff'd on different grounds,* 565 F. 2d (2d Cir. 1977).

The First and Ninth Circuits, however, have held that negligence is the appropriate standard in a government enforcement action, *SEC v. World Radio Mission,* 544 F. 2d 535, 541 n. 10 (1st Cir. 1976); *SEC v. Arthur Young & Co.,* No. 77-1768 at 3 (9th Cir. 1979); *see also, SEC v. Geotek,* 426 F. Supp. 715, 726 (N.D. Cal. 1976).

2d 795-796. Thus, the conflict between the decision below and *John Nuveen & Co., Inc.,* is complete.

These conflicts justify the grant of certiorari to review the judgment below.

II.

The decision below raises significant and recurring problems concerning whether the requirement of scienter is applicable to SEC actions to enjoin violations of §10(b) of the 1934 Act and §17(a) of the 1933 Act.

The Second Circuit's opinion in this case addresses itself to the important recurring question concerning the standard of culpability to be employed in enforcement actions by the SEC pursuant to Sections 10(b) and 17(a). In *Ernst & Ernst v. Hochfelder,* 425 U.S. 187, 193 n. 12 (1976) this Court left open the question of the extent to which proof of scienter might be required in injunction actions brought by the SEC. Efforts by the SEC to protect investors through its use of injunctive relief under these sections are common, and both litigants and lower courts urgently need the assistance of this Court in understanding whether scienter is a necessary element in an action for injunctive relief under §10(b) and §17(a). Among the unanswered questions thus posed are:

(1) Whether this Court's analysis and holding in *Hochfelder* concerning the need for an allegation of scienter for a private cause of action for damages under Section 10(b) and Rule 10b-5 applies equally to SEC injunctive proceedings? Clearly, the Second Circuit has held that the scienter requirement enunciated in *Hochfelder* is not applicable to government enforcement action brought under §§10(b) and 17(a) On the other hand, the Fifth Circuit in *Blatt,* 583 F. 2d at 1330-1332 felt that "*Hochfelder's* analysis applies forcefully to this issue *sub judice.*"

Obviously, the time has come for this Court to decide the question that it explicitly opened in *Hochfelder*, 425 U.S. 194 n. 12.

(2) Whether the language and history of §10(b) are dispositive of the appropriate standard of liability, or whether the arguments of policy and purpose are compelling?

The Second Circuit believes that the language of §10(b) alone is not determinative of the issue, but that resort to legislative history and purpose is proper. The Fifth Circuit, however, felt no need to look beyond the statute itself. Such a deep division over the standard that the SEC needs to prove in an enforcement action requires attention and resolution by this Court.

(3) Whether Section 17(a) should be read in harmony with *Hochfelder* to require a showing of scienter before an injunction will issue pursuant to that section?

The Second Circuit here also holding that a requirement of scienter is not necessary for SEC injunction actions brought pursuant to §17(a). Again, however, a division exists because the Seventh Circuit in *John Nuveen & Co.*, 554 F.2d 790, has found that scienter is required under §17(a).

It should be noted that this Court's opinion in *Hochfelder* has led many courts and commentators[4] to disagree as to whether scienter is the appropriate requirement in an enforcement action brought by the SEC. Such discussions, coupled with the number of enforcement actions brought by the SEC, underscore the desirability of a thorough examination of the problem by this Court so that litigants and lower courts may properly gauge the proper standard to be applied under §10(b) and §17(a) enforcement actions.

4. *See* Appendix, pages 24a and 26a, *infra*.

CONCLUSION

For these reasons, a writ of certiorari should issue to review the judgment and opinion of the Second Circuit.

Respectfully submitted,

s/ Barry M. Fallick

s/ Kenneth J. Platzer

Attorneys for Petitioner

(Counsel for petitioner appreciate the assistance of Sam Rosmarin, a law student, for his aid in preparation of this petition.)

APPENDIX

OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 830 — September Term, 1977

(Argued March 3, 1978; finally submitted December 8, 1978 — Decided March 12, 1979)

Docket No. 77-6091

Filed Mar. 12, 1979
A. Daniel Fusaro, Clerk

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

v.

PETER E. AARON,

Defendant-Appellant,

and

E.L. AARON & CO., INC., LAWN-A-MAT CHEMICAL & EQUIPMENT CORP., EDWARD L. AARON, PETER E. AARON, NORMAN LAWRENCE SCHREIBER, DONALD DARWIN JACOBSON, DANIEL DORFMAN, and FERNANDO ERAZO,

Defendants.

Opinion of the United States Court of Appeals for the Second Circuit

BEFORE:

ANDERSON, FEINBERG and TIMBERS, *Circuit Judges.**

Appeal from a permanent injunction entered after an evidentiary hearing in the Southern District of New York, Lee P. Gagliardi, *District Judge,* [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,043 (S.D.N.Y. May 5, 1977), enjoining Peter E. Aaron from violating the registration and antifraud provisions of the federal securities laws, the other seven named defendants having consented to the entry of permanent injunctions against them.

Affirmed.

Paul Gonson, Associate General Counsel, Securities and Exchange Commission, Washington, D.C. (Harvey L. Pitt, General Counsel, Jacob H. Stillman, Assistant General Counsel, Angela M. Desmond and Glynn L. Mays, Attorneys, Securities and Exchange Commission, Washington, D.C., on the brief), *for plaintiff-appellee.*

Bert L. Gusrae, New York, N.Y. (John Lowy, and Gusrae, Greene & Kaplan, New York, N.Y., on the brief), *for defendant-appellant.*

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* Pursuant to §0.14 of the Rules of this Court, this appeal is being determined by Judges Feinberg and Timbers who are in agreement on this opinion. Judge Anderson, who heard the argument, unfortunately died on May 2, 1978. Prior to his death, Judge Anderson voted to affirm and was in agreement with his colleagues on all issues in the case. He did not have the opportunity, however, to see this opinion prior to his death.

Opinion of the United States Court of Appeals for the Second Circuit

TIMBERS, *Circuit Judge:*

On this appeal from a permanent injunction entered after an evidentiary hearing in the Southern District of New York, Lee P. Gagliardi, *District Judge,* [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,043 (S.D.N.Y. May 5, 1977), enjoining Peter E. Aaron from violating the registration and antifraud provisions of the federal securities laws, we find the following to be the essential issues presented:

(1) Whether the district court erred in holding that Aaron's managerial and supervisory responsibilities with a broker-dealer firm, despite his lack of corporate title, made him subject to a permanent injunction enjoining him from violating the registration and antifraud provisions of the federal securities laws.

(2) Whether the district court erred in holding that Rule 144 under the 1933 Act does not provide an exemption from the registration provisions of that Act for controlling persons who sold shares, allegedly pursuant to Rule 144, to a broker who then sold them to a second broker for public sale without compliance with Rule 144.

(3) Whether the district court erred in holding that the SEC is not required to establish scienter as an element of a government enforcement action to enjoin violations of §10(b) of the 1934 Act or of §17(a) of the 1933 Act.

(4) Whether the district court erred in granting the permanent injunction under all the circumstances of this case.

For the reasons below, we agree in all respects with the district court's holdings on the essential issues stated above and we affirm in its entirety the permanent injunction as entered.

I.

We assume familiarity with Judge Gagliardi's excellent district court opinion. We accept his adequate findings of fact, Fed. R. Civ. P. 52(a), and we agree with his conclusions of law. We summarize here only those facts necessary to an understanding of our rulings on the legal issues stated above.

(A) *Peter Aaron's Responsibilities With E.L. Aaron & Co.*

During the period in question, appellant Peter E. Aaron ("Aaron") was employed by E.L. Aaron & Co. ("Aaron & Co." or "the firm"). Aaron & Co. was a broker-dealer registered with the Securities and Exchange Commission ("SEC"). The firm's principal office was in New York City. Aaron's father, Edward L. Aaron, was president and sole shareholder of Aaron & Co.

Aaron had been employed by the firm for 15 years. He served as his father's assistant. He was the firm's trouble shooter and the liaison between the firm's various departments, including operations, sales and the trading room.

Aaron maintained the so-called due diligence files for securities in which the firm made markets. In connection with his supervision of the firm's sales force, Aaron conducted sales meetings with registered representatives. At these meetings sales techniques were discussed. He also monitored the registered representatives' trading — by advising them of their monthly production figures, by informing them when any of their clients were late in payment, and by discouraging the representatives from exceeding their individual selling capacities.

As compensation for his services, Aaron received salary, bonuses and expenses at a level comparable to that of his father, the firm's president. Aaron, however, was not registered with the National Association of Securities Dealers ("NASD") as a principal of Aaron & Co. He held no corporate office in the firm.

(B) *Offer And Sale Of Lawn-A-Mat Stock*

In November 1974, Aaron & Co. opened a branch in Roslyn Heights, New York. Norman Schreiber, a registered representative of Aaron & Co., was appointed branch manager of the new office. Donald Jacobson, also an Aaron & Co. registered representative, was assigned to assist Schreiber. The Roslyn Heights office was essentially a two-man operation.

From November 1974 through September 1975, Aaron & Co. made a market in the common stock of Lawn-A-Mat Chemical & Equipment Corp. ("LAM"). In doing so, Schreiber and Jacobson contacted stockholders of LAM and its franchise-dealers by phone and by mail to solicit orders for LAM stock. In the course of this promotion, Schreiber and Jacobson made false and misleading statements to prospective purchasers of LAM. Among the statements made were some to the effect that LAM was planning or in the process of manufacturing a new type of small car and a tractor. In fact LAM had no plans to manufacture a car or tractor. Schreiber and Jacobson also made projections of substantial increases in the price of LAM stock and misleading statements about LAM's financial condition. There was no basis in fact for these projections and statements, since LAM had experienced significant losses during the period involved.

Some of the persons contacted complained to LAM officers about these statements. The LAM officers informed both Schreiber and Jacobson that their statements were false.

When the false and misleading statements continued despite these warnings, LAM's attorney contacted Aaron. He did so twice by telephone during the period involved, informing Aaron of the continuing false and misleading statements by his sales representatives.

Since Aaron was in charge of LAM's due diligence files, he had ample independent reason to know that the information about LAM being disseminated by Schreiber and Jacobson was untrue. Although Aaron notified Jacobson of the LAM attorney's complaint, he did nothing whatsoever to stop the false and misleading statements being made by Schreiber and Jacobson.

(C) *The Aaron & Co./J.W. Weller & Co./Dorfman Transactions*

In November 1974, a representative of Aaron & Co. telephoned Daniel Dorfman, who was then the president, principal stockholder and a director of LAM, to solicit the sale by Dorfman of 1000 shares of LAM common stock. Since Dorfman was a controlling person of LAM, his shares could not be sold unless registered under §5 of the 1933 Act or unless the sale of the unregistered stock qualified for an exemption from registration pursuant to Rule 144 under the 1933 Act. In view of the fact that Aaron & Co. precipitated the entire transaction by arranging for the sale of shares from Dorfman to Weller and by soliciting customers' buy orders in anticipation of the transfer of the shares from Weller to Aaron & Co., the sale of the shares to the public obviously did not qualify for a Rule 144 exemption, as we hold below.

In an attempt to enable Aaron & Co. to sell Dorfman's unregistered stock without qualifying for a Rule 144 exemption, the firm arranged the following transaction. Aaron contacted J.W. Weller & Co., Inc. ("Weller"), another broker-dealer, and suggested that Weller act as an intermediary for sales from Dorfman to Aaron & Co. The proposal was that Dorfman would sell his shares to Weller which, as "agent" of the selling shareholder, would sell the shares to Aaron & Co., which in turn would solicit buyers for the shares. Weller agreed. The transaction was consummated. Daniel Dorfman sold 1,000 shares.

Similarly, in February 1975, a representative of Aaron & Co. persuaded Fred Dorfman, who was then vice-president and a director of LAM, to sell 20,000 shares of LAM common stock in the same manner. As with Daniel Dorfman, Fred Dorfman was a controlling person. He was directed to transfer his shares to Weller, which in turn delivered them to Aaron & Co. for public sale.

The SEC commenced the instant enforcement action in the district court on February 26, 1976. It sought preliminary and final injunctive relief pursuant to §20(b) of the 1933 Act, 15 U.S.C. §77t(b)(1976), and §21(d) of the 1934 Act, 15 U.S.C. §78u(d) (1976). The complaint charged Aaron and three other defendants with violating and aiding and abetting violations of, the registration provisions of §§5(a) and 5(c) of the 1933 Act, 15 U.S.C. §§77e(a) and 77e(c) (1976). The complaint also charged Aaron and seven other defendants with violating, and aiding and abetting violations of, the antifraud provisions of §17(a) of the 1933 Act, 15 U.S.C. §77q(a) (1976), §10(b) of the 1934 Act, 15 U.S.C. §78(b) (1976), and Rule 10b-5 promulgated under the 1934 Act, 17 C.F.R. §240.10b-5 (1978). The seven defendants other than Aaron consented to the entry of permanent injunctions against them.

After a three day evidentiary hearing, Judge Gagliardi on May 5, 1977 filed a comprehensive, well reasoned opinion, holding that Aaron had violated the registration and anti-fraud provisions as charged in the complaint; and that the SEC was entitled to a permanent injunction enjoining Aaron from further such violations.

From the final judgment entered on Judge Gagliardi's opinion, the instant appeal has been taken.

II.

In the light of these facts and prior proceedings, we turn first to the question whether Aaron, despite his lack of official title, was properly enjoined pursuant to §20(b) of the 1933 Act and §21(d) of the 1934 Act[1] from violating the registration and antifraud provisions of the federal securities laws — on the basis of violations committed by the brokerage firm's registered representatives. We hold that, because Aaron exercised managerial and supervisory authority over the firm, he was equally responsible for the fraudulent representations made by the firm's salesmen. The permanent injunction was properly entered against him.

Several courts have held the managerial and supervisory personnel who held official title in a broker-dealer firm have a duty to prevent or halt actions by firm employees in violation of the federal securities laws. *See, e.g., Gross v. SEC,* 418 F.2d 103 (2 Cir. 1969) (Moore, J.); *Stevens v. Abbott, Proctor & Paine,* 288 F. Supp. 836, 847 (E.D. Va., 1968). The presence or absence of an official title, however, has not been a decisive factor in determining liability. Thus, in *Gross v. SEC, supra,* we affirmed a decision by the Commission holding that the vice-president of a broker-dealer was liable under §10(b) of the 1934 Act and

§17(a) of the 1933 Act for aiding and abetting actions by the firm and its employees which were found to be in violation of the antifraud provisions of the Acts. Although Gross held the official title of vice-president, Judge Moore did not focus on his status as an officer, but instead emphasized his "participation in the management of the firm." 418 F.2d at 107.

This is not the only context in which our decision has turned on a defendant's functions within the firm, rather than on his corporate title. In *Colby v. Klune,* 178 F.2d 872, 873 (2 Cir. 1949), we held that the absence of an official title does not preclude liability under §16(b) of the 1934 Act, 15 U.S.C. §78p(b) (1976). We held that the term "'officer'" as used in §16(b) should be interpreted in light of the duties performed by the particular corporate employee and that "[i]t is immaterial how his functions are labelled." 178 F.2d at 873. Similarly, in *SEC v. Galaxy Foods, Inc.,* 417 F. Supp. 1225, 1247 (E.D.N.Y. 1976), *aff'd mem.,* 556 F.2d 559 (2 Cir.), *cert. denied,* 434 U.S. 855 (1977), the district court, in granting injunctive relief, emphasized the defendants' involvement in the firm's actions rather than their official status within the firm.

Appellant here claims that his lack of corporate title insulates him from liability based on the actions of the firm's employee. This claim, if upheld, would seriously undermine the purposes of the antifraud provisions of the securities laws and deprive customers of brokerage firms of the protections which they expect when dealing with professionals in the industry. As the Supreme Court observed in *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 203 (1976), §10(b) of the 1934 Act was designed as a "catch-all clause" to enable the Commission to deal with new manipulative devices. Courts have been extremely flexible in interpreting the requirements of this section.

Consistent with this pragmatic approach, we hold that appellant's lack of corporate title does not foreclose the entry against him of a permanent injunction based on the clearly fraudulent activities of the firm's representatives.[2] The district court found that, while Aaron never registered as a principal with the NASD[3] nor held an official title at Aaron & Co., he participated in management decisions, monitored the trading of the firm's representatives, and, with his father, exercised supervisory responsibilities over the firm's employees. *SEC v. E.L. Aaron & Co., Inc.*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,043 at 91,684 (S.D.N.Y. May 5, 1977). Moreover, the evidence clearly supports the district court's finding that Aaron had supervisory responsibilities over the Roslyn Heights branch office.

Based on his participation in the management of the firm and his supervisory responsibilities, we hold that Aaron aided and abetted the violations by the firm's salesmen and therefore is subject to a permanent injunction. To permit the management of broker-dealers to avoid the consequences of their supervisory responsibilities and thus to escape injunctive and other liability imposed upon them by the antifraud provisions of the federal securities laws merely because they lack corporate title, would create a particularly vacuous and pernicious distinction. We decline to do so.

III.

We turn next to the question whether, under Rule 144,[4] the sale of unregistered LAM stock by controlling persons of LAM to Weller & Co., and ultimately to Aaron & Co. for resale to the public, is exempt from the registration requirements of §5 of the 1933 Act.[5] We hold that this sham transaction is not exempt under Rule 144.

Section 5 of the 1933 Act, read in conjunction with §§4(1) and 2(11) of the 1933 Act,[6] prohibits the issuer of any security or controlling persons of the issuer from selling or offering to sell a security in interstate commerce unless a registration statement is in effect. The registration statement is designed to assure public access to material facts bearing on the value of publicly traded securities and is central to the Act's comprehensive scheme for protecting public investors. *See generally, SEC v. Ralston Purina Co.*, 346 U.S. 119, 124 (1952). Accordingly, any exemption from this requirement must be strictly construed. *Milnarik v. M-S Commodities, Inc.*, 320 F. Supp. 1149, 1151 (N.D. Ill. 1970), *aff'd*, 457 F.2d 274 (7 Cir.) (Stevens, J.), *cert. denied*, 409 U.S. 887 (1972). *See SEC v. Ralston Purina Co., supra*, 346 U.S. at 126; *SEC v. North American Research & Development Corp.*, 424 F.2d 63, 71-72 (2 Cir. 1970).

Two such exemptions are those provided for in §4(4) of the 1933 Act, 15 U.S.C. §77d (1976), and in Rule 144. Section 4(4) provides an exception from registration for "brokers, transactions executed upon customers orders . . . but not the solicitation of such orders." The Commission in Rule 144 has clarified the meaning of "brokers' transactions" by defining them to encompass only transactions where a broker

> "(1) Does no more than execute the order or orders to sell the securities *as agent* for the person for whose account the securities are sold; . . . .
>
> (2) Neither solicits nor arranges for the solicitation of customers' orders to buy the securities in anticipation of or in connection with the transaction; . . ." (emphasis added). Rule 144(g), 17 C.F.R. §230.144(g) (1978).

Appellant argues that these exemptions are applicable to the Dorfmans' sale of LAM stock to Weller & Co. and the subsequent sale to Aaron & Co. and, therefore, that registration was not required. We disagree.

It is clear that, if Aaron & Co. had purchased the Dorfmans' shares directly from the Dorfmans and then had attempted to sell such shares to the public, with all other circumstances remaining the same, the transaction would have failed to comply with the exemption requirements for two reasons. First, with respect to the sale of LAM shares by the Dorfmans, Aaron & Co. solicited the sale of LAM shares with an eye to acquiring the shares for its own account; thus, Aaron & Co., by acting as *principal* for its own account rather than as *agent* of the seller, would not have complied with the requirement of Rule 144(g)(1). Second, Aaron & Co., by engaging in the solicitation of customers' orders to buy LAM shares in anticipation of the Dorfman sale, would have failed to comply with §4(4) and Rule 144(g)(2).

Aaron & Co., however, did not purchase the shares directly from the Dorfmans. In order to circumvent the restrictions of Rule 144 and §4(4), Aaron & Co. concocted a scheme which called for interposing another brokerage firm — Weller & Co. — to act as middlemen in the transaction Weller & Co. would purchase the shares from the Dorfmans and then, pursuant to a prearranged agreement, would resell the shares to Aaron & Co. Although the scheme clearly was an attempt to obfuscate the true nature of the transaction and to evade the intent of the exemption restrictions, appellant nevertheless argues that the transaction technically complied with the Rule.

We hold that the fact that Aaron & Co. did not purchase the shares directly from the controlling persons is inconsequential. Aaron & Co. still precipitated the entire

transaction. They solicited the sale of shares from the Dorfmans in violation of Rule 144(g)(1). They determined the price. They introduced the Dorfmans to Weller & Co. and arranged for the sale of shares from the Dorfmans to Weller & Co. and then from Weller & Co. to Aaron & Co. Moreover, they solicited customers' buy orders in anticipation of the acquisition of the Dorfmans' unregistered shares. If we were to sanction this obviously sham transaction, we would be undermining the statutory requirement of registration when securities are transferred from controlling persons into the market. We decline to do so. We hold that the transaction failed to comply with the restrictions of Rule 144 and §4(4).[7]

IV.

We turn next to appellant's claim that the district court erred in holding that the SEC is not required to establish scienter as an element of a government enforcement action to enjoin violations of §10(b) of the 1934 Act or of §17(a) of the 1933 Act.

(A) *Section 10(b) of the 1934 Act.*

In *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976), the Court held that proof of scienter is a necessary element in a private damage action under §10(b).[8] The Court, however, explicitly left open the question whether scienter would be required in future injunction actions. 425 U.S. at 194 n. 12. In granting the permanent injunction below, the district court found that appellant's conduct in connection with the misleading statements was sufficient to establish scienter.[9] Nevertheless, we find it unnecessary to reach the question whether Aaron's conduct would support a finding of scienter, since we hold that the scienter requirement enunciated in *Hochfelder* is not

applicable to government enforcement actions brought under §§10(b) and 21(d) of the 1934 Act. Consistent with the pre-*Hochfelder* decisions of this Court, we continue to hold that allegations and proof of negligence alone will suffice, for the reasons stated below.

Although various courts[10] and commentators[11] have examined the question of what degree of culpability is required for injunction actions after *Hochfelder*, we have not had the occasion to rule squarely on that issue to date.[12] Accordingly, our analysis must begin with the reasoning of the Supreme Court in *Hochfelder* itself.

In holding that scienter is required for private damage actions under §10(b), the Supreme Court in *Hochfelder* relied on three factors: (1) the language of §10(b); (2) the legislative history of the 1934 Act; and (3) the relationship of §10(b) to the other express civil remedies[13] and the effect of a scienter requirement on the overall statutory scheme of the securities laws. Looking first to the language of §10(b), the Court observed that the use of the words "manipulative" and "deceptive" in conjunctive with "device or contrivance" indicated an intent to proscribe "only knowing or intentional misconduct." 425 U.S. at 197. Examination of the legislative history of §10(b) and its relationship to other provisions of the securities laws reinforced the Court's conclusion that scienter was required for private damage actions under §10(b). *Id.* at 201-211.

It has been suggested that the analysis employed in *Hochfelder* should apply with equal force to the question of scienter as a requisite element in a government injunction action. *SEC v. Blatt*, 583 F.2d 1325, 1333 (5 Cir. 1978). *See also Ernst & Ernst v. Hochfelder, supra*, 425 U.S. at 217 (Blackman, J., dissenting — "the question whether negligent conduct violates the Rule should not depend upon the plaintiff's identity.") For

the reasons below and especially in the light of the carefully reasoned pre-*Hochfelder* decisions of this Court, we believe that there are compelling distinctions between private damage actions and government injunction actions so far as the scienter requirement is concerned.

Long before the Supreme Court's holding in *Hochfelder*, our Court had construed the language of §10(b) to require scienter in the context of private damage actions. *See, e.g., Lanza v. Drexel*, 479 F.2d 1277, 1301, 1305-06 (2 Cir. 1973) (en banc); *Shemtob v. Shearson, Hammill & Co.*, 448 F.2d 442, 445 (2 Cir. 1971); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 868 (2 Cir. 1968) (en banc) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969). On the other hand, we uniformly have held that the language and history of the section did not require a showing of scienter in an injunction enforcement action brought by the Commission. *See, e.g., SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 809 (2 Cir. 1975); *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1096 (2 Cir. 1972); *Hanly v. SEC*, 415 F.2d 589, 596 (2 Cir. 1969); *SEC v. Texas Gulf Sulphur Co., supra*, 401 F.2d at 854. In view of the policy considerations underlying the securities acts, it has been our view that the increased effectiveness of government enforcement actions predicated on a showing of negligence alone outweighed the danger of potential harm to those enjoined from violating the securities laws. *See, e.g., SEC v. Spectrum, Ltd.*, 489 F.2d 535, 541-42 (2 Cir. 1973); *SEC v. Texas Gulf Sulphur Co., supra*, 401 F.2d at 854-55, 868. Our decisions uniformly have held that a negligence standard should be applied in a government enforcement action because such actions are brought for the purpose of providing maximum protection for the investing public, as contrasted with the purpose of private damage actions which are brought to obtain monetary relief for individual investors. *See SEC v. Manor Nursing Centers, Inc., supra;*

Hanly v. SEC, supra. This distinction was succinctly stated in our recent decision in *SEC v. Coven,* 581 F.2d 1020, 1027-28 (2 Cir. 1978) (Mansfield, J.):

> "The essential nature of an SEC enforcement action is equitable and prophylactic; its primary purpose is to protect the public against harm, not to punish the offender."

The Court's decision in *Hochfelder* in our view has not altered the fact that different policy considerations should govern in SEC enforcement actions, in contrast to private damage actions, under §10(b). Indeed, the Court itself appears to have recognized this when it expressly left open the question now before us. 425 U.S. at 194 n.12.

Moreover, an examination of the same three factors that the Supreme Court relied on in concluding that scienter is required for private damage actions under §10(b) indicates to us that scienter should not be required in a government enforcement action.

The first factor — the language of §10(b) — of course is the same regardless of whether the action is brought by the SEC or a private individual. Contrary to appellant's assertions, however, we do not believe that the language of the section alone is determinative of the issue. As the judicial interpretation of the section demonstrates, different courts have construed the language differently. *See* The Supreme Court, 1975 Term, *supra* note 8, at 258 & n. 35; Note, 77 Colum. L. Rev., *supra* note 11, at 425 n. 43. Where the statutory language is unclear, the Supreme Court has held that resort to legislative history and purpose is proper. *See, e.g., Train v. Colorado Public Interest Research Group,* 426 U.S. 1, 10 (1976); *Cass v. United States,*

417 U.S. 72, 78 (1974); *Perry v. Commerce Loan Co.,* 383 U.S. 392 (1966); *NLRB v. Fruit & Vegetable Packers,* 377 U.S. 58, 62 (1964); *Cox v. Roth,* 348 U.S. 207, 209 (1955); *United States v. Rosenblum Truck Line Association,* 315 U.S. 50 (1942).

As the Court stated in *Hochfelder,* however, the legislative history of §10(b) is "bereft of any explicit explanation of Congress' intent." 425 U.S. at 201. Pointing out that the 1934 Act as a whole was aimed at clearly intentional fraud, the Court nevertheless concluded, in the context of an implied right of action for damages, that the legislative history of the section did not conflict with the conclusion the Court reached through textual analysis of the section.

The Court in *Hochfelder* was dealing with the question of a judicially implied right of action as to which it is not surprising that there was very little legislative history on the scienter issue. In the past, our Court has looked for guidance in defining the requirements for a private right of action under §10(b) to the common law of misrepresentation and deceit. *Lanza v. Drexel, supra,* 479 F.2d at 1291-93, 1306. In defining the requirements for an SEC injunction action based on violations of §10(b), however, we have looked to §21(d) formerly §21(e) of the 1934 Act, the explicit statutory provision which authorizes the SEC to bring such an action. *See SEC v. Texas Gulf Sulphur Co., supra,* 401 F.2d at 855 & n.21.

Legislative discussion of §21(d) indicates that scienter was not intended to be required in SEC injunction actions.[14] The predecessor of §21(d) — §21(e) of the 1934 Act, 15 U.S.C. §78u(e) (1970) — provided for an injunction action to be brought by the SEC "[w]henever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this chapter, or of any rule or

regulation thereunder. . . ." When §21(e) was replaced by §21(d), at the time of the enactment of the Securities Acts Amendments of 1975, 15 U.S.C. §78u(d) (1976), Congress expressly indicated its approval of the approach taken by our Court with regard to injunction actions brought under §10(b):

> "Private actions frequently will involve more parties and more issues than the Commission's enforcement action, thus greatly increasing the need for extensive pretrial discovery. In particular, issues related to matters of damages, such as scienter, causation and the extent of damages, are elements *not* required to be demonstrated in a Commission injunctive action." (citation omitted) (emphasis in original). S. Rep. No. 75, 94 Cong., 1st Sess. 76 (1975).

It would be difficult to find a clearer indication, at the time of the enactment of §21(d), that Congress intended to exempt SEC injunction actions from the scienter requirement applicable to private actions.

Finally, we are satisfied that rejection of a scienter requirement for SEC injunction actions is consistent with the overall enforcement scheme of the securities acts. The *Hochfelder* holding reflected the Court's concern that the absence of a scienter requirement for private damage actions under §10(b) would render superfluous the statutory scheme of "express civil remedies" and would "significantly broaden the class of plaintiffs who may seek to impose liability upon accountants and other experts who perform services or express opinions." 425 U.S. at 214 n.33. Such concerns strike us as not applicable to SEC enforcement actions. An examination of the statutory scheme indicates that there are no comparable

provisions which would be nullified by permitting SEC enforcement actions to be predicated on a showing of negligence. Indeed, to sanction §10(b) injunctive relief on proof of negligence would be to harmonize the requirements of that section with the standards governing similar prophylactic provisions of the 1933 Act.[15]

We reject appellant's contention that a permanent injunction was erroneously entered against him under §10(b) because his actions failed to support a finding of scienter. We hold that, in the context of an enforcement action brought by the SEC to enjoin violations of §10(b), proof of scienter on the part of the defendant is *not* required.[16]

(B) *Section 17(a) of the 1933 Act.*

Appellant also contends that the holding in *Hochfelder* requires a finding of scienter for SEC injunction actions brought pursuant to §17(a) of the 1933 Act, 15 U.S.C. §77q(a). It follows from our holding above under §10(b) of the 1934 Act that a fortiori scienter is not a requisite element of a government enforcement action to enjoin violations of §17(a) of the 1933 Act.

While courts in other circuits since *Hochfelder* have divided on whether the holding in *Hochfelder* should apply to actions brought under §17(a),[17] the rule in this Circuit, as carefully enunciated by Judge Mansfield in *SEC v. Coven, supra,* 581 F.2d at 1026-28, unequivocally is that scienter is *not* required in an SEC injunction action under §17(a). Focusing on the absence of any terminology in §17(a) comparable to the words "manipulative or deceptive" "device" or "contrivance" which the Court found persuasive in *Hochfelder,* our Court in *Coven* held that "we see no reason to give §17(a) a similarly narrow reading." *Id.* at 1026-27.

We agree and accordingly we reject appellant's claim that the SEC was required to prove scienter with respect to that part of this injunction action brought pursuant to §17(a).

V.

Finally, we must consider whether, under all of the circumstances of this case, the district court erred in granting a permanent injunction enjoining Aaron from future violations of the securities laws.

This Court consistently has held — over a period of two decades — that the district court has broad discretion to enjoin possible future violations of the securities laws when past violations have been shown and this determination will not be disturbed on appeal unless it is clearly shown that the district court abused its discretion. *SEC v. Manor Nursing Centers, Inc., supra,* 458 F.2d at 1100; *SEC v. Texas Gulf Sulphur Co., supra,* 446 F.2d at 1306-07; *SEC v. Culpepper,* 270 F.2d 241, 250 (2 Cir. 1959). *See United States v. W.T. Grant Co.,* 345 U.S. 629, 633 (1953). The critical question in determining whether the public interest requires the imposition of a permanent injunction is "whether there is a reasonable likelihood that the wrong will be repeated." *SEC v. Manor Nursing Centers, Inc., supra,* 458 F.2d at 1100. *Accord, SEC v. Management Dynamics, Inc.,* 515 F.2d 801, 807 (2 Cir. 1975).

It is well established that the commission of past fraudulent conduct gives rise to an inference that continued violations may be expected in the future. *SEC v. Management Dynamics, Inc., supra,* 515 F.2d at 807; *SEC v. Manor Nursing Centers, Inc., supra* 458 F.2d at 1100. In making its determination, the district court properly considered such factors as the nature of appellant's past violations, *United States v. W.T. Grant Co.,*

supra, 345 U.S. at 633, and the fact that appellant continues to maintain that his conduct was lawful and innocent. *SEC v. Manor Nursing Centers, Inc., supra,* 458 F.2d at 1101. *Accord, SEC v. Commonwealth Chemical Securities, Inc.,* 574 F.2d 90, 100 (2 Cir. 1978); *SEC v. Universal Major Industries,* 546 F.2d 1044, 1048 (1976). Not only did appellant permit the two salesmen of the firm to engage in fraudulent activities for five months after he had been informed of their false and misleading representations, but he continues to adhere to the position that he had no supervisory responsibilities over them because of his lack of title in the firm. The district court also found that appellant was responsible for arranging the sham transaction for the sale of the Dorfmans' shares in an attempt to circumvent the restrictions of Rule 144.

In addition to the foregoing factors which alone are sufficient to justify a permanent injunction, the district court found that appellant had acted with scienter in committing the violations charged. While we have held that scienter is not a requisite element of a SEC injunction action under §10(b) or §17(a), the court's findings that appellant acted with scienter underscore the need for an injunction. *SEC v. Commonwealth Chemical Securities, Inc., supra,* 574 F.2d at 100; *SEC v. Universal Major Industries, supra,* 546 F.2d at 1048.

Accordingly, we hold that the district court properly exercised its discretion in granting the permanent injunction enjoining appellant from committing further violations of the securities laws.[18]

Affirmed.

FOOTNOTES

1] Section 20(b) of the 1933 Act, 15 U.S.C. §77t(b) (1976), provides in relevant part:

> "Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this subchapter, or of any rule or regulation prescribed under authority thereof, it may in its discretion, bring an action in any district court of the United States . . . to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond."

Section 21(d) of the 1934 Act, 15 U.S.C. §78u(d)(1976), provides in relevant part:

> "Whenever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of this chapter, the rules or regulations thereunder . . . it may in its discretion bring an action in the proper district court of the United States . . . to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond."

2] The district court found that two of the firm's registered representatives made a number of serious and blatant misrepresentations to Aaron & Co. customers concerning

aspects of LAM's activities and financial condition. With the exception of certain statements regarding LAM's plans to build a car and tractor, appellant does not dispute that these false statements were made. He does contend, however, that there was insufficient evidence to support the district court's finding that LAM was not manufacturing a car or tractor and did not plan to do so. After reviewing the record, we hold that the district court's finding was not clearly erroneous, Fed. R. Civ. P. 52(a), but indeed was supported by the evidence.

3] Appellant contends that since he was not registered as a principal with the NASD, he can not be held liable for violations at an office already managed by a registered principal. In view of our holding that a defendant's liability depends upon the extent and nature of his responsibilities and not on his title, we hold that the district court properly rejected appellant's contention. Moreover, we find no error in the court's refusal to receive in evidence an exchange of certain letters relating to Aaron's need to register with the NASD. In view of our holding, these letters were irrelevant to the issue of whether Aaron aided and abetted violations of the securities laws.

4] 17 C.F.R. §230.144 (1978).

5] 15 U.S.C. §77e (1976).

6] Section 4(1) of the 1933 Act, 15 U.S.C. §77d(1) (1976), makes §5 inapplicable to transactions by anyone "other than an issuer, underwriter or dealer." Section 2(11) of the 1933 Act, 15 U.S.C. §77b(11) (1976), defines "issuer" as including, *inter alia*, "any person directly or indirectly controlling . . . the issuer." Appellant concedes that the Dorfmans were controlling persons of LAM for purposes of the 1933 Act.

7] The SEC recently has promulgated an amendment to Rule 144 which permits a person selling securities under the rule to deal directly with a market maker in lieu of engaging a broker. Securities Act Release No. 5979, reprinted in [Current] Fed. Sec. L. Rep. (CCH) ¶81,731 (Sept. 19, 1978). Previously, a seller was forbidden from dealing directly with a market maker since the latter is continuously soliciting orders for shares. The Commission, however, now views the rule's requirements as "more stringent than necessary", *id.* at 80,930, and has revised the rule specifically to permit a seller to deal with a market maker.

The amendment, however, does not alter in any way our holding in the instant case. Aside from the fact that the amended rule was not in effect at the time of the instant transaction, the Commission explicitly has noted, "[t]he prohibitions against the solicitation of buy orders . . . have not been changed and therefore will continue to apply." *Id.* at 80,931. Thus, had the Dorfmans approached Aaron & Co. about a possible sale of LAM stock, the amended rule would have permitted Aaron & Co. to buy from the Dorfmans. However, the amended rule still would have prohibited Aaron & Co.'s actions in soliciting the Dorfmans to sell and in soliciting other customers buy orders in anticipation of the purchase of the Dorman's shares.

8] The Court defined scienter as "intent to deceive, manipulate, or defraud," 425 U.S. at 193 (footnote omitted). Various commentators nevertheless have debated what the Court meant by that definition. *See, e.g.,* Bucklo, The Supreme Court Attempts to Define Scienter Under Rule 10b-5: *Ernst & Ernst v. Hochfelder,* 29 Stan. L. Rev. 213 (1977); Haimoff, Holmes Looks at *Hochfelder* and 10b-5, 32 Bus. Law. 147 (1976); The Supreme Court, 1975 Term, 90 Harv. L. Rev. 56, 259 & nn.47 and 48 (1976); Note, Recklessness Under Section 10(b);

Weathering the *Hochfelder* Storm, 8 Rutgers-Camden L.J. 325, 342-51 (1977). Since we hold that scienter is not a requisite element of a government injunction action, we need not determine in this context what constitutes scienter within the Supreme Court's definition in *Hochfelder.*

9] The district court stated:

> "While negligence alone may suffice as a standard for liability in Commission enforcement proceedings, . . . the fact that Peter Aaron intentionally failed to terminate the false and misleading statements made by Schreiber and Jacobson, knowing them to be fraudulent, is sufficient to establish his scienter under the securities laws." *SEC v. E. L. Aaron & Co., supra,* [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,043 at 91,685.

10] *Compare* those cases which have held that scienter is required, *e.g., SEC v. Blatt,* 583 F.2d 1325 (5 Cir. 1978); *SEC v. Willis,* ——F. Supp. ——(D.D.C. 1978), 47 U.S.L.W. 2423 (U.S. Jan. 9, 1979); *SEC v. Cenco, Inc.,* 436 F. Supp. 193, 200 (N.D. Ill. 1977); *SEC v. Bausch & Lomb, Inc.,* 420 F. Supp. 1226, 1241 (S.D.N.Y.), *aff'd on different grounds,* 565 F.2d 8 (2 Cir. 1977) (not reaching scienter issue) *with* those cases which suggest negligence will suffice, *e.g., SEC v. Arthur Young & Co.,* No. 77-1768 at 3 (9 Cir. Feb. 1, 1979); *SEC v. World Radio Mission,* 544 F.2d 535, 541 n.10 (1 Cir. 1976); *SEC v. Geotek,* 426 F. Supp. 715, 726 (N.D. Cal. 1976). Still other courts have discussed the question but have found it unnecessary to rule squarely on the issue. *E.g., SEC v. Savoy Industries, Inc.,* 587 F.2d 1149 (D.C. Cir. 1978); *SEC v. American Realty Trust,* 586 F.2d 1001 (4 Cir. 1978). *But cf., Edward J. Mawod & Co. v.*

SEC, No. 77-1495 at 16-18 (10 Cir. Jan. 24, 1979) (scienter required for SEC order suspending and revoking broker-dealer registration).

11] Berner & Franklin, Scienter and Securities and Exchange Commission Rule 10b-5 Injunctive Actions: A Reappraisal in Light of *Hochfelder*, 51 N.Y.U.L. Rev. 769 (1976); Haimoff, *supra*, 32 Bus. Law. at 166; Harkleroad, Requirements for Injunctive Actions Under The Federal Securities Laws, 2 Journal of Corp. Law 481 (1977); Note, The Scienter Requirement in SEC Injunctive Enforcement of Section 10(b) After *Ernst & Ernst v. Hochfelder*, 77 Colum. L. Rev. 419 (1977); Note, Scienter and Injunctive Relief Under Rule 10b-5, 11 Ga. L. Rev. 879 (1977); Comment, Scienter and SEC Injunctive Suits, 90 Harv. L. Rev. 1018 (1977); Note, SEC Enforcement Actions to Enjoin Violations of Section 10(b) and Rule 10b-5: The Scienter Question, 5 Hofstra L. Rev. 831 (1977); Note, Scienter's Scope and Application In Light of *Hochfelder*, 52 Notre Dame Law. 925 (1977).

12] *SEC v. Coven*, 581 F.2d 1020, 1026 n.10 (2 Cir. 1978), *cert. denied*, ____ U.S. ____ (1979), 47 U.S.L.W. 3586 (U.S. March 5, 1979); *SEC v. Commonwealth Securities, Inc.*, 574 F.2d 90, 102 (2 Cir. 1978); *Arthur Lipper Corp. v. SEC*, 547 F.2d 171, 180-181 n.6 (2 Cir. 1976), *cert. denied*, 434 U.S. 1009 (1978); *SEC v. Universal Major Industries*, 546 F.2d 1044, 1047 (2 Cir. 1977).

13] The Court noted that Congress, in structuring express civil remedies under the securities acts, clearly specified whether recovery was to be premised on negligence or knowing and intentional conduct. 425 U.S. at 207. To permit recovery of damages under §10(b) for negligent conduct would "nullify the effectiveness of the carefully drawn procedural restrictions on these express actions." *Id.* at 210.

14] Indeed, an examination of the development of SEC injunction provisions in Congress, beginning with the precursor of both §17 and §20 of the final 1933 Act, 15 U.S.C. §77q and §77t (1970), demonstrates congressional rejection of a scienter requirement. The Senate draft of the 1933 provision required a showing of scienter for equitable relief:

> "It shall be unlawful for any person, firm, corporation, or other entity, directly or indirectly, in any interstate sale, promotion, negotiation, advertisement, or distribution of any securities *willfully* to employ any device, scheme, or artifice or to employ any 'dummy', or to act as any such 'dummy', with the intent to defraud or to obtain money or property by means of any false pretense, representation, or promise, or to engage in any transaction, practice or course of business relating to the interstate purchase or sale of any securities which operates or would operate as a fraud upon the purchaser." Section 13 S.875, 73d Cong., 1st Sess., 77 Cong. Rec. 2982 (1933) (emphasis added).

However, the compromise drafted by the Conference Committee and adopted by both the House and the Senate ultimately rejected the Senate proposal and excluded mention of specific fraudulent intent altogether. H.R. Rep. No. 152, 73d Cong., 1st Sess. (1933).

In connection with the creation of the SEC in 1934, the legislative history indicated that Congress was vitally concerned with the need to maintain the flexibility necessary for effective enforcement. *See, e.g.*, S. Rep. No. 792, 73d Cong., 2d Sess. 5 (1934); H.R. Rep. No. 1383, 73d Cong., 2d Sess. 7 (1934). By

incorporating in the 1934 Act the same pattern of culpability requirements established by the 1933 Act, *see*, Section 210 of Title II of the 1934 Act, ch. 404, §210, 48 Stat. 881 (1934). Congress clearly indicated its rejection of a scienter standard for injunctive relief. This was made particularly clear by Congress' express rejection of an amendment proposed to limit injunctive relief under the 1933 Act through the establishment of a scienter standard. 78 Cong. Rec. 8703 (1934). See generally, Note, 77 Colum. L. Rev., *supra* note 11, at 429-35.

15] See note 14, *supra*.

16] Having ruled as we have on this question, we agree with the characteristically perceptive observation of our colleague, Judge Friendly, that the question is one "on which the final word will not rest with us." *SEC v. Commonwealth Securities, Inc., supra*, 574 F.2d at 101.

17] *Compare SEC v. American Realty Trust Co.*, 586 F.2d 1001 (4 Cir. 1978); *SEC v. World Radio Mission*, 544 F.2d 535, 541 n. 10 (1 Cir. 1976); *SEC v. Shiell*, [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,190 (N.D. Fla. 1977); *SEC v. Southwest Coal & Energy Co.*, 439 F. Supp. 820, 826 (W.D. La. 1977); *SEC v. Geoteck*, 426 F. Supp. 715, 726 (N.D. Cal. 1976) (scienter not required under §17(a)) *with Sanders v. John Nuveen & Co.*, 544 F.2d 790 (7 Cir. 1977), *and SEC v. Cenco, Inc.*, 436 F. Supp. 193, 199-200 (N.D. Ill. 1977) (scienter required under §17(a)).

18] We note Judge Friendly's cogent observations regarding the evolving judicial attitude toward the issuance of injunctions on the basis of past violations. *SEC v. Commonwealth Chemical Securities, Inc., supra*, 574 F.2d at 99-100. In our view, Judge Friendly's observations would be particularly helpful in

reviewing the district court's exercise of discretion in a close case. But the instant case most assuredly is not a close one. As with the principal defendants in *Commonwealth* with respect to whom Judge Friendly had "no difficulty in sustaining the injunction", *id.* at 100, we hold likewise with respect to Judge Gagliardi's exercise of discretion in enjoining Aaron from future violations of the securities laws.

OPINION OF UNITED STATES DISTRICT COURT, SOUTHERN DISTRICT OF NEW YORK

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

-against-

E.L. AARON & CO., INC., LAWN-A-MAT CHEMICAL & EQUIPMENT CORP. EDWARD L. AARON, PETER E. AARON, NORMAN LAWRENCE SCHREIBER, DONALD DARWIN JACOBSON, DANIEL DORFMAN, FERNANDO ERAZO,

Defendants.

76 Civ. 907

APPEARANCES:

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Opinion of United States District Court, Southern District of New York

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GAGLIARDI, D.J.

The complaint in this action filed on February 26, 1976 by plaintiff Securities and Exchange Commission ("Commission") charged eight defendants with violating and aiding and abetting violations of the anti-fraud provisions of the Securities Act of 1933 ("Securities Act"), Section 17(a), 15 U.S.C. §77q(a),[1] and the Securities Exchange Act of 1934 ("Exchange Act"), Section 10(b), 15 U.S.C. §78j(b)[2], and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5[3], in connection with the offer and sale of the common stock of Lawn-A-Mat Chemical & Equipment Corp. ("LAM"). Four of these defendants, including Peter Aaron, were also charged with violating and aiding and abetting violations of the registration provisions of the Securities Act, Sections 5(a) and 5(c), 15 U.S.C. §§77e(a)[4] and 77e(c)[5], in connection with the offer and sale of LAM stock. Thereafter, all of the defendants in this action except Peter Aaron consented to the entry of final judgments of permanent injunction.

The court conducted a three day evidentiary hearing on the Commission's motion for entry of a preliminary injunction and final judgment of permanent injunction[6] enjoining Peter Aaron from violating the registration and anti-fraud provisions of the securities laws. For the reasons set forth below, the court finds that Peter Aaron has violated both the registration and anti-fraud provisions and grants the Commission's motion for a preliminary and permanent injunction.

The Commission brings this action pursuant to section 21(b) of the Securities Act, 15 U.S.C. §77t(b), and section 21(d) of the Exchange Act, 15 U.S.C. §78u(d) to enjoin these alleged violations. This court has jurisdiction of this action pursuant to Section 22(a) of the Securities Act, 15 U.S.C. §77v(a), and Section 27 of the Exchange Act, 15 U.S.C. §78aa. The defendant has engaged in certain acts and practices within the Southern District of New York constituting, in part, the violations of the securities laws alleged. Such actions were effected by making use of the means and instrumentalities of interstate commerce and of the mails.

The court having considered the pleadings, the testimony of witnesses and the documents in evidence makes the following findings of fact and conclusions of law as required by Rule 52 Fed. R. Civ. P.

Findings of Fact

1. E.L. Aaron & Co., Inc. ("Aaron & Co.") was a New York corporation with its principal offices located in New York, New York. During the period from November 1974 through September 1975 ("the relevant period") Aaron & Co. also operated a branch office in Roslyn Heights, New York. During the relevant period Aaron & Co. was a broker-dealer registered with the Commission and a member of the National Association of Securities Dealers, Inc. ("NASD"). During the relevant period Aaron & Co. had as many as 50 employees including 25 full-time and 15 part-time registered representatives. Aaron & Co. is no longer doing business.

2. Edward Aaron was the president, sole officer and sole stockholder of Aaron & Co. He spent almost all of the business day in the trading room executing orders and trading securities.

3. Defendant Peter Aaron is the son of Edward Aaron. He was employed at Aaron & Co. for a period of 15 years. During the relevant period he was a registered representative, assistant to the president; and the liason between the operations department, the registered representatives and the trading room. He also maintained due diligence files for the securities in which Aaron & Co. made markets. He was not registered with the NASD as a principal of Aaron & Co.

4. Peter Aaron performed additional duties at Aaron & Co. He conducted sales meetings with registered representatives at which sales techniques were discussed, and monitored the trading of representatives advising them of their monthly production figures, informing them of their clients who were late in payment, and ensuring that the representatives did not exceed their individual selling capacities. He also participated with his father in the hiring of Aaron & Co. employees and performed other duties.

5. In sum, Peter Aaron, along with his father, had supervisory responsibility over Aaron & Co.'s registered representatives and other employees. He and his father only were authorized to sign checks at Aaron & Co. Peter Aaron received a salary, bonuses, expenses and other payments from Aaron & Co. at a level comparable to Edward Aaron. He expected to inherit complete ownership of Aaron & Co. from his father. In sum, Peter Aaron functioned in a managerial and supervisory capacity over all the activities at Aaron & Co. In particular, he supervised the registered representatives and received and answered complaints about their activities.

6. Norman Schreiber ("Schreiber") at all times relevant was associated with Aaron & Co. as a registered representative and was branch manager of Aaron & Co.'s Roslyn Heights office.

7. Donald Jacobson ("Jacobson") at all times relevant was associated with Aaron & Co. as a registered representative working in the Roslyn Heights office.

8. LAM is a New York corporation engaged in the business of selling franchises and products for lawn care and provides combines, trailers and tractors to franchisees for the application of lawn care products, which are also supplied by LAM. At all times relevant the common stock of LAM was registered with the Commission pursuant to Section 12(g) of the Exchange Act, 15 U.S.C. 781(g), and was traded in the over-the-counter market. LAM filed all required forms with the Commission, such forms and other reports of LAM were maintained in the files of Aaron & Co.

9. Daniel Dorfman at all times relevant was a director and major stockholder of LAM. From October, 1974 through November, 1975 Daniel Dorfman was not involved with the day-to-day operations of LAM.

10. Fernando Erazo ("Erazo"), during all times relevant was a director, chief operating officer and, at various times, president and executive vice president of LAM.

Violations of the Anti-Fraud Provisions

A. False and Misleading Representations

11. During the relevant period Aaron & Co. made a market in the common stock of LAM. LAM furnished to Schreiber and Jacobson copies of its stockholders' list and franchise-dealers' list. Schreiber and Jacobson contacted persons on these lists by phone and by use of the mails to solicit orders for LAM stock.

12. Some of the persons contacted complained or inquired of LAM officers and employees regarding the representations

made by Schreiber or Jacobson. Erazo and Milton Kean ("Kean"), attorney for LAM, subsequently requested Schreiber and Jacobson to halt making false and misleading statements in connection with these solicitations.

13. Some of the false or misleading information that Schreiber or Jacobson told prospective purchasers of LAM included the representation that LAM was planning or in the process of manufacturing a new type of small car and a tractor. Investors contacted were told among other things that the car would be manufactured in a venture with a Japanese outfit and the new car would be coming out in six weeks. LAM, however, was not manufacturing a car or tractors and did not plan to do so.[7] Furthermore, both Erazo and Kean informed Schreiber and Jacobson that their statements were false.

14. Schreiber and Jacobson also supplied prospective investors false or misleading information concerning the financial condition of LAM and projected substantial increases in the price of the stock. Their projections of the increasing sales and earnings of LAM had no basis in fact as LAM continued losing money during the relevant period.

B. Peter Aaron's Knowledge and Failure to Act

15. Kean spoke to Peter Aaron by telephone on two occasions during the relevant period, the first in April 1975 and the second subsequent, to inform him that Schreiber and Jacobson were making false and misleading statements in connection with their campaign of selling LAM stock. Specifically, Kean informed Peter Aaron that Schreiber and Jacobson, without any basis in fact, were informing prospective purchasers of LAM stock that LAM was planning or already

manufacturing a car and a tractor. Kean also informed Peter Aaron that Schreiber and Jacobson were making misrepresentations about the financial condition of LAM.

16. Peter Aaron, in addition to being informed by Kean, had reason to know that the statements by Schreiber and Jacobson were false or misleading. As the individual at Aaron & Co. responsible for maintaining the due diligence files which included LAM's files, Peter Aaron was aware that LAM by its reports did not indicate that it was building or planning a car or a tractor and did indicate a deteriorating financial condition.

17. After Kean made these objections to him, Peter Aaron notified Jacobson of Kean's complaint but did nothing to correct or stop the false and misleading misrepresentations which Schreiber and Jacobson then continued to make.

Violations of the Registration Provisions

18. During the relevant period representatives of Aaron & Co., through use of the telephone and the mails, continuously solicited customers for the purchase of LAM common stock. Peter Aaron knew of this solicitation.

19. During the relevant period representatives of Aaron & Co. solicited the sale of 1,000 shares of LAM common stock from Daniel Dorfman and 20,000 shares of LAM common stock from Fred Dorfman, a Vice President and Director of LAM. This LAM stock which was unregistered was sold pursuant to the exemption from the registration provisions of the Securities Act provided by Rule 144, 17 C.F.R. 230.144.

20. At about the same time Aaron & Co. arranged with J.W. Weller & Co., Inc. ("Weller & Co."), a New Jersey broker-dealer, for Weller & Co. to act as an intermediary in

transactions in which Aaron & Co. would purchase LAM stock from its own customers. Peter Aaron participated in those transactions by making the initial contact with Weller & Co. and it was with his approval that the Dorfman transactions were effected. Aaron & Co. arranged the sale of the Dorfman's stock to Weller & Co. and then purchased the same shares from Weller & Co. In each case representatives of Aaron & Co. told the Dorfmans to send their stock to Weller & Co., neither of them previously having done business with nor heard of Weller & Co. In each case Aaron & Co. purchased for its own account the Dorfman's stock through Weller & Co. In the case of Fred Dorfman's stock, Aaron & Co. purchased it in three blocks of 5,000, 5,000 and 10,000 shares from Weller & Co.

21. In sum and effect the Dorfmans sold their stock directly to Aaron & Co. Weller & Co. was a mere intermediary directed by Aaron & Co. for the purposes of these transactions.

22. In each case Aaron & Co. purchased the Dorfman's stock for its principal account. These shares were then sold at a later date to the public from its principal account. In so doing Aaron & Co. was acting as a principal or dealer for its own account and not as an agent or broker for a customer.

23. Counsel for Aaron & Co. never advised Peter Aaron or anyone at Aaron & Co. that the arrangement with Weller & Co. to act as a prearranged intermediary in the sale of the Dorfman's stock was in compliance with §5(a) and (c) of the Securities Act.

Conclusions of Law

Violations of the Anti-Fraud Provisions

Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, as

judicially construed and applied, mandate fair dealing in connection with the offer or sale of any securities. *See SEC v. Capital Gains Research,* 375 U.S. 180, 201 (1963); *SEC v. Galaxy Foods, Inc.,* 417 F. Supp. 1225, 1244 (E.D.N.Y. 1976).

In this case Aaron & Co., through its registered representatives Schreiber and Jacobson, was continuously during the relevant period soliciting sales of LAM stock. In connection with the solicitation, Schreiber and Jacobson knowingly made false and misleading statements to prospective customers concerning LAM's activity in manufacturing a car and a tractor and concerning LAM's financial condition. Although employees of LAM and their counsel informed Schreiber and Jacobson that their representations were false, and the LAM reports on file at Aaron & Co. indicated that these representations had no basis in fact, Schreiber and Jacobson continued to make them. In sum, Jacobson and Schreiber knowingly and intentionally made false and misleading statements in connection with the offer and sale of the common shares of LAM, clear violations of the anti-fraud provisions of the securities laws. *See, e.g., SEC v. Texas Gulf Sulphur Co.,* 401 F.2d 833 (2d Cir. 1968) (*en banc*), *cert. denied,* 394 U.S. 976 (1969); *Hanly v. SEC,* 415 F.2d 589 (2d Cir. 1969); *SEC v. Cooper,* 402 F. Supp. 516 (S.D.N.Y. 1975).

Peter Aaron knew of the activities of Schreiber and Jacobson. He was called twice by Milton Kean, counsel for LAM, and told that Schreiber and Jacobson were giving prospective customers false information about LAM's manufacture of a car and a tractor and false information on the financial condition of LAM. Kean had previously called Schreiber and Jacobson directly and told them without effect to cease their activity. Peter Aaron had reason to know, independent of Kean's notification, that what Schreiber and Jacobson were representing was false and misleading. As the

individual responsible for the due diligence files, which included up-to-date reports on LAM, Peter Aaron had all of the current information on LAM, none of which indicated the company's activities or projected growth that Schreiber and Jacobson were reporting. Peter Aaron stated to Kean that he would stop the misrepresentations. However, he did nothing to stop the activity and only contacted Jacobson and told him to contact Kean.

Peter Aaron had a managerial and supervisory position at Aaron & Co. While he was neither registered as a principal with the NASD, nor denominated as an officer of Aaron & Co., based upon his involvement with the affairs of the firm, his participation in management decisions, his compensation and his close association with his father, he functioned in a managerial capacity at Aaron & Co. *Cf. SEC v. E.J. Albanese Co. Inc.,* CCH Fed. Sec. L. Rep. ¶95,778 (S.D.N.Y. 1976). In such capacity he was specifically responsible for supervising the registered representatives. In fact, when Kean called Aaron & Co. to complain about Schreiber and Jacobson, he was first connected with Edward Aaron who told him that such complaints should be made to Peter Aaron.

Consequently, Peter Aaron, although never an officer, director or shareholder of Aaron & Co., by virtue of his active participation in the management of the firm and his knowledge both of the firm's solicitation of LAM stock and the false and misleading statements being made by Schreiber and Jacobson in connection with that solicitation, must be held responsible along with Schreiber and Jacobson for the fraudulent representations that were made. *See Gross v. SEC,* 418 F.2d 103, 106 (2d Cir. 1969); *SEC v. Galaxy Foods, Inc., supra,* 417 F. Supp. at 1246-47. While Peter Aaron himself did not make any misrepresentations, by failing to stop Schreiber and Jacobson, he wilfully aided and abetted their violations of the anti-fraud

provisions of the securities laws.[8] *See Gross v. SEC, supra; SEC v. Galaxy Foods, Inc., supra; SEC v. E.J. Albanese & Co., Inc., supra; SEC v. Charles A. Morris & Assoc., Inc.,* CCH Sec. L. Rep. ¶93,756 at 93,306 (W.D. Tenn. 1973); *see also SEC v. Barraco,* 438 F.2d 97 (10th Cir. 1971).

While negligence alone may suffice as a standard for liability in Commission enforcement proceedings, *SEC v. Universal Major Industries Corp.,* 546 F.2d 1044 (2d Cir. 1976); *SEC v. World Radio Mission, Inc.,* CCH Fed. Sec. L. Rep. ¶95,751 (1st Cir. 1976); *contra SEC v. Bauch & Lomb, Inc.,* CCH Fed. Sec. L. Rep. ¶95,722 (S.D.N.Y. 1976), appeal docketed, No. 73 Civ. 2458 (2d Cir. Sept. 16, 1976), the fact that Peter Aaron intentionally failed to terminate the false and misleading statements made by Schreiber and Jacobson, knowing them to be fraudulent, is sufficient to establish his scienter under the securities laws. *See SEC v. Universal Major Industries, supra* at 1046-47; *SEC v. Galaxy Foods, Inc., supra,* 417 F. Supp. at 1245-46. Therefore, Peter Aaron's conduct under either a negligence or a scienter theory of liability violated and aided and abetted violations of the anti-fraud provisions of the securities laws.

Violations of the Registration Provisions

Section 5 of the Securities Act prohibits the sale of a security by any person unless a registration statement is in effect as to that security or unless there is an exemption from the requirements of the section. In this case 21,000 shares of LAM stock sold by Daniel and Fred Dorfman, officers and directors of LAM, were without registration. Violations of §5(a) and (c) thus follow automatically, unless some exemption from registration is available.

The burden of establishing the availability of an exemption from the requirements of Section 5 is on Peter Aaron, the one claiming the exemption. *SEC v. Ralston Purina Co.,* 346 U.S. 119, 126 (1953); *SEC v. Culpepper,* 270 F.2d 241, 246 (2d Cir. 1959); *SEC v. Galaxy Foods, Inc., supra,* 417 F. Supp. at 1242.

Defendant relies on the exemption provided in Rule 144, 17 C.F.R. 230.144, which, in conjunction with §§4 and 2(11) of the Securities Act, 15 U.S.C. §77d and 77(b)(11), permits the public sale of certain unregistered securities, like the 21,000 shares sold by the Dorfmans, if the sale is made in accordance with *all* the conditions of the Rule. In this case it is undisputed that the only provisions of Rule 144 possibly not complied with were 144(f) and (g).

Rule 144(f) provides:

> (f) Manner of Sale. The securities shall be sold in "brokers' transactions" within the meaning of Section 4(4) of the Act and the person selling the securities shall not (i) solicit or arrange for the solicitation of orders to buy the securities in anticipation of or in connection with such transactions or (ii) make any payment in connection with the offering or sale of the securities to any person other than the broker who executes the order to sell the securities.

Rule 144(g) provides:

> (g) Brokers' Transactions. The term "brokers' transactions" in Section 4(4) of the Act shall for the purposes of this rule be deemed to include transactions by a broker in which such broker —

> (1) does no more than execute the order or orders to sell the securities as agent for the person for whose account the securities are sold; and receives no more than the usual and customary broker's commission;
>
> (2) neither solicits nor arranges for the solicitation of customers' orders to buy the securities in anticipation of or in connection with the transaction; provided, [certain exceptions not relevant here] . . . .

Aaron & Co., through transactions in LAM stock arranged and approved by Peter Aaron, did not comply with Rule 144(f) and (g) for two reasons. First, Aaron & Co., in arranging for the Dorfmans' sale of LAM stock, acted as a principal for its own account and never as a mere agent for the seller. Employees of Aaron & Co. solicited the Dorfmans' sales and, as a market-maker for LAM stock, purchased the stock for its own account. Accordingly, the sales were not "brokers' transactions" because Aaron & Co. was not acting "as agent" for the Rule 144 sellers as required by Rule 144(f) and (g)(1). Second, Aaron & Co. was soliciting customers' orders to buy LAM securities in connection with the Dorfmans' sales in violation of Rule 144(g)(2).

Aaron & Co. and Peter Aaron cannot avoid these requirements of Rule 144 by arranging for the sales of the Dorfmans' stock through an intermediary. Weller & Co.'s participation in the transaction was a sham to evade the intent of the Rule while feigning technical compliance.[9] If Aaron & Co. had purchased the Dorfmans' stock from Weller & Co. or another broker-dealer in an open market interdealer transaction,

Aaron & Co. would not have violated Rule 144. In this case, however, Weller & Co. was not acting "as agents" for the Dorfmans but only as an intermediary-agent for Aaron & Co. who arranged the whole transaction.

Aaron & Co. solicited the sale and arranged the price. Neither Daniel nor Fred Dorfman ever heard of or dealt with Weller & Co. and each was first told by agents of Aaron & Co. that their sale would be through Weller & Co. Aaron & Co. effectively purchased the stock directly from the Dorfmans. This conduct was not in compliance with Rule 144 and as a result defendant has not met his burden of establishing an exemption to Section 5 of the Securities Act. Therefore, defendant in concert with others at Aaron & Co. directly and indirectly violated and aided and abetted violations of §5(a) and (c) of the Securities Act.[10]

Defendant contends, as a defense, relying on *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 191-92 n. 7 (1976), that if liability may be found to exist it must be based on scienter rather than negligence. However, *Hochfelder* only passed upon a private suit for damages in a §10(b) context and not upon Commission injunctive actions under §5. The law of this circuit is that negligence, and not scienter, is all that is required in a Commission injunction proceeding under §5. *SEC v. Universal Major Industries, supra,* 546 F.2d at 1046-47. However, even if scienter were required, defendants acted with knowledge or reckless disregard of the illegality of the arrangement with the Dorfmans and Weller & Co. This is sufficient to establish scienter. *SEC v. Universal Major Industries Corp., supra,* at 1047; *citing, Lanza v. Drexel & Co.,* 479 F.2d 1277 (2d Cir. 1973).

Defendant's last defense, that he relied upon the advice of counsel in arranging the Rule 144 transactions, is without basis in the evidence. While good faith reliance on advice of counsel may be a factor to consider in deciding whether to grant injunctive relief, *SEC v. Manor Nursing Centers, Inc., supra,* 458 F.2d at 1101, *SEC v. Senex Corp.,* 399 F. Supp. 497, 507 (E.D. Kty. 1975), in this case there was no reliance because defendant did not follow the opinion of his counsel. *SEC v. Senex Corp., supra; United States v. Hill,* 298 F. Supp. 1221, 1235 (D. Conn. 1969).

Counsel for Aaron & Co. only advised that in the sale of Rule 144 stock the seller be referred to several other brokers, and that Aaron & Co. could then buy those shares in an open market transaction. Counsel specifically stated that he never advised Peter Aaron or anyone at Aaron & Co. to have Aaron & Co. arrange for Rule 144 stock to be sold to another broker-dealer with whom Aaron & Co. already had an arrangement to purchase the stock for subsequent sale to its own customers. Peter Aaron, having not followed the advice of counsel, cannot rely on this defense to his violation of §5(a) and (c) of the Securities Act.

Injunctive Relief

The standard governing the issuance of injunctive relief in a Commission enforcement action is whether there is a reasonable likelihood that the violations will be repeated. *SEC v. Culpepper,* 270 F.2d 241, 249-50 (2d Cir. 1959), *SEC v. Scott, Gorman Municipals, Inc.,* 407 F. Supp. 1383, 1387 (S.D.N.Y. 1975); *SEC v. Raga,* CCH Fed. Sec. L. Rep. ¶95,222 (S.D.N.Y. 1974).

In this case, Peter Aaron while not presently in the securities business clearly expressed at trial a strong interest in

returning to the securities industry. He is currently working in the related field of commodities trading. Under the circumstances, in this court's view, this indicates a likelihood of Peter Aaron's further violations of these securities laws in the future. In light of the nature and extent of the violations of the anti-fraud and registration provisions, the defendant's failure to recognize the wrongful nature of his conduct and the likelihood of the defendant repeating his violative conduct, the court is convinced that the public interest requires issuance of the Commission's requested preliminary and permanent injunctions. *See SEC v. Universal Major Industries Corp., supra,* 546 F.2d at 1048; *SEC v. Management Dynamics, Inc., supra,* 515 F.2d at 807; *SEC v. Manor Nursing Centers, Inc., supra,* 458 F.2d at 1100-02.

Submit judgment on five days' notice.

U.S.D.J.

Dated: New York, New York
May 3, 1977.

FOOTNOTES

1. Section 17(a) provides:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly —
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

2. Section 10(b) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —

> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

3. Rule 10b-5 provides:

> Employment of Manipulative and Deceptive Devices
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or

> would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

4. Section 5(a) provides:

> Unless a registration statement is in effect as to security, it shall be unlawful for any person, directly or indirectly —
>
> (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or
>
> (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

5. Section 5(c) provides:

> It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior

> to the effective date of the registration statement) any public proceeding or examination under section 8.

6. Pursuant to Rule 65(a)(2) Fed. R. Civ. P., the Commission moved at the commencement of the hearing, with the consent of the defendant, for consolidation of their motions for preliminary and permanent injunctions.

7. Only Daniel Dorfman, speaking on his own behalf and not for LAM, ever even mentioned a prospective plan that he and not LAM intended to build a car, and he never spoke in the concrete terms described by Schreiber and Jacobson.

8. Defendant's claim that his liability should be measured solely by the "control person" standard of §20(a) of the Exchange Act is without merit. In Commission enforcement actions, §20(a) was not intended as the sole measure of employer liability. *SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 812 (2d Cir. 1975). Section 20(a) has not preempted or restricted operation of general rules in the securities field. *Fey v. Walston & Co., Inc.*, 493 F.2d 1036, 1052 (7th Cir. 1974).

9. The Commission recognized the illegality of such technical compliance in Securities Act Release No. 5223, CCH Fed. Se. L. Rep. ¶ 78,487 at 81,061 (January 11, 1972), announcing the official adoption of Rule 144 and interpreting its provisions:

> In view of the objectives and policies underlying the Act [Securities Act of 1933], the rule shall not be available to any individual or entity with respect to any transaction which, although in technical compliance with the provisions of the

> rule, is part of a plan by such individual or entity to distribute or redistribute securities to the public. In such case, registration is required.

10. This holding is consistent with the Commission's position in its staff interpretative letters clarifying the meaning and application of Rule 144. *Carolina Securities Corp.*, CCH Fed. Sec. L. Rep. ¶80,803 (Oct. 7, 1976) and ¶80,853 (Dec. 8, 1976); *Herzog & Co., Inc.*, CCH Fed. Sec. L. Rep. ¶79,801 (May 15, 1974); *Ag-Met Inc.*, CCH Fed. Sec. L. Rep. ¶79,796 (May 2, 1974).